Accounting and Auditing

Independent Auditor's Report: Messages Conveyed and Implications

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Abstract: Auditing plays a crucial role in the business environment by providing assurance services to the public so as to decrease information risk by increasing the reliability of financial information provided by the business entities. As the final product of the audit, the audit report is a way by which the auditor communicates with the public the findings of the audit process. The auditor's report is the only aspect of the work of auditor that can be available to the public. Thus, users are likely to assess the auditor's professionalism and competence by this report. The purpose of this study is to address the meaning and implication of the audit report in addition to a discussion of the messages perceived from the auditor's report. Differences in perceptions of the meaning of the auditor's report may exist between the auditors and users. Users may misperceive the nature and scope of the audit function and the level of assurance when they read the audit report

Keywords: Auditing; auditor's report; auditor's responsibilities

JEL Classification: M40; M42

1. Background

The auditor's report is the final step in the audit process. As the final product of the audit, the auditor report is a way by which the auditor communicates with the public the findings of the audit process. The auditor's report is the only aspect of the work of auditor that can be available to the users. Thus, users of the financial statements are likely to assess the auditor's professionalism and competence by this report. In addition, the legal responsibility of the auditor may be determined by the auditor's report. As a result, the auditor's report, it should clearly describe the auditor's work. In addition, there must be a common understanding of the terminologies used in the audit report.

International Standards on Auditing (ISA) requires external auditors to explain their responsibilities explicitly in the auditor's report. ISA 700 states that the

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auditor's report shall include a section with the heading "Auditor's Responsibility." In this section, the auditor indicates that his/her responsibility is to express an opinion on the financial statements based on the audit and to obtain **reasonable assurance** about whether the financial statements are free **from material misstatements**". Thus, auditors are concerned with material misstatements, and are not responsible for the detection of misstatements that are not material to the financial statements. The intent is to indicate that the results are based on professional judgment and to point out that there may be some information risk associated with the audited financial statements (Elder et al. 2010).

Although auditors explain their responsibilities explicitly in the auditor's report users misunderstand the responsibilities of the auditors. Research conducted in different economic environments indicates that public believes that auditors are responsible for performing very wide range of duties. Many users believe that auditors are responsible for guaranteeing the accuracy of the financial statements, detecting minor theft of client's assets and detecting other illegal acts that indirectly affect the financial statements (Porter et al. 2008). Apparently, users lack understanding of the audit function and assume the external auditors to perform wide range of duties which are not of their responsibilities. The main purpose of this study is to address the meanings and implication of the audit report in addition to a discussion of the messages perceived from the auditor's report

The remainder of this paper is organized as follows: the second section addresses the meanings of the audit report, section three describes report on the responsibility of the auditors and entity's management, the fourth section report on the going concern, section five presents report on the internal control system and section six concludes.

2. Meanings of the Audit Report

Users of the audit report may misperceive the nature and scope of the audit function and the level of assurance provided by the auditor when they read the audit report. The users often assume audit to have a wider scope than it actually have (Gold et al. 2009). In addition, users of the financial statements might not correctly interpret some technical terms contained in the standard audit report such as "...present fairly…" in the opinion paragraph (McEnroe and Martens, 2001).

Until 1988, the (short form audit report) remained unchanged in the United States of America as well as in the other countries. The expanded audit report was adopted first in the United States of America in 1988. In the United Kingdom, the short form audit report was used prior to the adoption of the expended audit report in 1993. An example of the short form audit report that was used in the United

Kingdom before 1993 is presented in figure 1 (Porter et al. 2008, p. 551). It can be observed from this audit report that the short form report is so brief. It is composed only of two paragraphs (introductory and opinion paragraphs). In addition, the report did not explain the nature of the audit and did not indicate the responsibilities of the auditors and the entity's management. Furthermore, the report was titled as "report of the auditors" without using the word "independent" in the report title.

In the United States, the Commission on Auditors' Responsibilities (the Cohen Commission, 1978) found that the short form audit report was confusing to the users rather than informing them. The commission also noted that the users are unable to distinguish between the responsibilities of the auditors and those of the entity's management. The Cohen Commission also recommended that the audit report should be adjusted to describe more explicitly the role and responsibilities of the external auditors (Boyd et al. 2001). As a result of these shortcomings of the short form audit report, new auditing standards on audit report prescribing the use of an expanded audit report have been issued by; the American Institute of Certified Public Accountants (AICPA), the Auditing Practice Board (ABP; UK), Canadian Institute of Chartered Accountants (CICA), and the International Federation of Accountants (IFAC) since 1988. Unlike the short form audit report, the new expanded audit report includes (Porter et al. 2008):

- The use of the phrase "report of independent auditor" instead of " report of auditor",
- A brief description of the audit process,
- A statement explaining the respective responsibilities of the directors of audittee firm and auditors of the financial statements of the company,
- A statement that an audit is planned and performed in order to obtain sufficient appropriate evidence to provide reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or errors.

The International Auditing and Assurance standard Board's (IAASB) requirements for the format and contents of the audit report is organized in International Standards on Auditing (ISA) 700 "Forming an Opinion and Reporting on Financial Statements". In the revised version of the ISA 700, the IAASB intends to provide new wording and information contents of the audit report so as to explain the responsibilities of the external auditor and the entity's management. The purpose is to ensure that the users of the financial statements understand the nature and scope of the audit, the responsibilities of the auditors and entity's management, and the level of assurance that is provided by the auditor's opinion. An example of standard unqualified audit report as required by the revised ISA 700 (effective in or after 15 December, 2009) is presented in figure 2.

Several prior studies found that the expanded audit report has helped in enhancing the understandability of the audit function by the public. Hartherly et al. (1991) pointed out that the expanded audit report gives a fuller understanding of the scope, nature and limitations of the audit work. The study also indicated that the expanded audit report has two potential effects upon users' perceptions of the audit report. On the one hand, it influences the perceptions of financial statements users concerning the audit and the auditor's responsibilities. On the other hand, it induces a change in the perceptions of the auditor and makes him/her focus on what is required. Furthermore Koh and Woo (1998) indicated that the wording modifications in the expanded audit report have significantly changed by the public's perceptions of the audit. On contrast, other studies found that there are differences in the perceptions o auditors and users in relation to the meaning of the audit report. For example, the study of Gold et al. (2009) found that difference between the perceptions of users and auditors regarding the information provided in the auditor's report still exist. The study also found that the detailed explanations of the auditor and management responsibilities and the task and scope of the audit in the auditors report are not effective in reducing theses differences in perceptions between auditors and users and partially even have a detrimental effect.

Different perceptions of auditors and financial statement users of the audit report are related to three main issues contained in the audit report. These issues are report on the responsibility of the auditors and management, report on the going concern and report on the internal control system. These issues are presented in this section as below.

2.1. Report on the Responsibility of the Auditors and Entity's Management

The responsibility of the auditor and the entity's management is considered as major issues that cause the differences between the perceptions of users and the auditors in relation to the audit report. Users of the financial statements often assume auditors to provide an absolute level of assurance when they read the auditor's report. However, the auditor's opinion on the financial statement provides a "reasonable" level of assurance (Gold et al. 2009, p.4). The auditor's responsibility section in the audit report stated clearly that the responsibility of the auditor is to obtain reasonable assurance about whether the financial statements are free from material misstatement

In addition, surveys conducted in UK, Australia, Canada, and New Zealand indicated that significant number of users believe that auditors are responsible for preparing the financial statements of the client and are responsible for verifying every transactions of the entity. The surveys also pointed out that some users believe that the unqualified audit report signifies that the auditor guarantees that the financial statements are accurate and the entity is financially secure (Porter et al. 2008). However, the preparation of the financial statements is the responsibility of the entity's management as clearly stated in the auditor's report. In addition, the auditors are not responsible for verifying every transaction in the entity or guarantee the accuracy of the financial statements because the audit opinion on the financial statements provides reasonable (not absolute) level of assurance.

Nair and Rittenberg (1987) examined the understanding of the auditors and sophisticated users (bankers) of various type of audit reports in the US. The findings of the study indicated that bankers place greater responsibility for the correctness of the financial statements on auditors and less responsibility on the entity's management. In addition, Bailey et al. (1983) examined the perceptions of the audit report by two different groups (professionals and the less knowledgeable members of the public). The respondents of the two groups indicated that the short form audit reports are misunderstood by many users. The study also concluded that more knowledgeable readers of the audit report perceive the auditor as less responsible for the information in the financial statements than the management. The above mentioned two studies were conducted before introducing the expanded audit report. These results indicated clearly that there are different perceptions about the responsibilities of the auditors and those of the entity's management between auditors and the public.

Several studies also examined the perceptions of users of on the expanded audit report. Kelly & Mohrweis (1989) found that bankers and investors reading the new expanded audit report (under SAS 58) tended to agree that the entity's management is responsible for the preparation of the financial statements. The study of Miller et al. (1993) also found that bank loan officers who read an expanded auditor's report are better able to identify the responsibilities for the preparation of financial statements by both management and the independent auditor than can loan officers who read old audit reports. The study also concluded that users become more familiar with the messages conveyed in the auditor's report and their implications.

On the other hand, recent studies have indicated differences in the perceptions between users and auditors regarding the responsibilities of auditors and management as stated in the expanded audit report. The study of Chong and Pflugrath (2008) concluded that the expanded audit report did not reduce these differences in the perceptions between shareholders and auditors. Additionally, Gold et al. (2009) found that the detailed explanations of the auditor and management responsibilities and the task and scope of the audit in the auditors report are not effective in reducing this expectation gap.

Thus, the expanded audit report does not seem to be a sufficient solution to the gap between the public and auditors in relation to the auditor and management responsibilities as perceived from the audit report. Providing more detailed descriptions of the responsibilities of management and the auditor or by changing the wording of audit reports appear to be unsuccessful attempts to reduce this gap. Therefore, further recommendations are proposed by many researchers in order to reduce this gap in relation to the auditor and management responsibilities as perceived in the audit report. Among these suggested recommendations is to educate users about the contents of the audit report. Furthermore the re-ordering of the sections of the report by placing the opinion at the start of the report may be useful in reducing the audit report expectation gap and worthy of further research (Gold et al. 2009).

2.2. Report on the Going Concern

The entity's management normally prepares financial statements under the going concern assumption. The going concern assumption states that an entity will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations. In this case, general purpose financial statements are prepared(ISA 570). When planning and performing the audit procedures and in the evaluation of the results of the audit, the auditor has the responsibility to evaluate whether the company is likely to continue as going concern. ISA 570 indicated that the auditor is responsible for obtaining sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements. The auditor should decide whether there is a material uncertainty about the entity's ability to continue as a going concern (ISA 570).

However, this does not indicate that the auditor is responsible for evaluating the financial health or guarantees the financial viability of the company. The auditor cannot predict such future events or conditions. Therefore, the absence of any reference to uncertainty (regarding continued as a going concern) in an auditor's report cannot be viewed as a guarantee of the entity's ability to continue as a going concern (ISA 570).

The auditor's consideration of the going concern assumption may make him/her modify the type of the audit report according to the circumstances. When the auditor has doubts about the ability of the entity to continue as a going concern but the entity provides adequate disclosure about the matter in the financial statement, the auditor shall express an unmodified (unqualified) opinion and include an emphasis of matter paragraph in the auditor's report (ISA 570). If adequate disclosure about the matter in question is not made in the financial statements, the auditor shall express a qualified opinion or adverse opinion as appropriate. In addition, if the auditor decides that the management uses the going concern assumption in the financial statements in inappropriate way, the auditor shall express an adverse opinion (ISA 570).

Some of users expect that the auditor is responsible for providing them with an early warning of the business failure. If a business failure occurs and the financial statements are latter determined to have been misstated, the public may claim that the auditor was negligent even if the audit was conducted in conformity with auditing standards (Elder et al. 2010). In response to that, audit profession has made continuing efforts to assess and revise auditing standards in order to reduce or eliminate this misunderstanding of the audit report by users. For example, in 1988, the AICPA issued Statement on Auditing Standards (SAS) No. 59 "The Auditor's Consideration of an Entity's Ability to continue as a going concern". SAS 59 was issued as a response to the criticism to the auditors as they did not take on enough responsibility for evaluating going concern. Several studies performed prior to SAS No. 59 indicated that more than half the companies entering bankruptcy did not receive a going-concern modified report in the period prior to bankruptcy (Guy and Sullivan, 1988). A question such as "how can a business fail shortly after receiving an unmodified audit report?" was raised by researchers and by the public.

In addition, the collapses of companies shortly after receiving an unmodified audit report still exist. For example, six of the ten largest companies that collapsed between 2001 and 2002 received unmodified auditor's opinions. Four of these six companies (WorldCom, Enron, Global Crossing, and UAL Corp) were clients of Arthur Andersen (Nogler, 2008). This series of accounting scandals led to the issuance of the Sarbanes-Oxley Act (2002). Since that time, auditors are more likely to give a going-concern modified audit opinion for financially stressed companies. Sarbanes-Oxley Act does not include new arrangements for going concern. However, auditor's behavior related to going-concern reporting changed in the post December 2001 period after the series of financial scandals for famous companies took place (Geiger et al. 2005).

Thus, the auditor's decision concerning report on going concern is difficult. Auditors are likely to be in a conflicting position between the client and users of the financial statements. Errors in making such a decision will be costly to the auditor. If the auditor provides a going concern modification to a client and this client does not fail in future, the auditor may loss the client. In contrast, if the auditor decided not to provide a going concern modification to a client that is financially distressed, the auditor is likely to face lawsuits from creditor or stakeholder in addition to the negative impact on the reputation of the auditing firm.

2.3. Report on the Internal Control System

ISA 700 indicates clearly that the entity's management is responsible for establishing and maintaining an entity's internal control system. Auditors are responsible for obtaining an understanding of the entity and its environment, including the entity's internal control. ISA 315 requires that the auditor shall obtain an understanding of internal control relevant to the audit of the financial statements. This understanding of internal control assists the auditor in identifying types of potential misstatements in the financial statements and factors that affect the risks of material misstatement. In addition, this understanding assists the auditors in designing the nature, timing and extent of further audit procedures. In addition, Sarbanes Oxley Act requires the entity's management of all publicly held companies to issue an internal control report that explicitly accept responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting. In addition, Sarbanes Oxley Act requires the auditor of the publicly held companies to report on the assessment made by the management about the effectiveness of the internal control

Prior research revealed that differences exist between the perceptions of auditors and the public about the report on the internal control. Research conducted in different countries indicated that users misunderstand the responsibilities of the auditors in relation to internal control. A study conducted by Fadzly and Ahmed (2004) in Malaysia pointed out that auditors and investors have significant different beliefs about the auditor's responsibility of internal control. In addition, the results of another studies conducted in Singapore (Best et al. 2001) and Egypt (Dixon and Woodhead, 2006) indicated that users of the financial statements believe that auditors are responsible for ensuring sound internal control in the company.

The differences between the perceptions between auditors and users in relation to reporting on internal control could be reduced by improving the report on internal control in the auditor's report. For example, the expanded audit report was able to reduce these differences. However, a study of Gist et al. (2004) concluded that auditors and users of the financial statements have different perceptions about internal control reporting required by SOX. Thus, the external auditor's report on internal control over financial reporting may broaden the differences between the perceptions of auditors and users in relation to reporting on internal control.

3. Conclusions

The auditor's report is the only aspect of the work of auditor that can be available to the public. Thus, users of the audit report are likely to assess the auditor's professionality and competence by this report. In addition, the legal responsibility of the auditor may be determined by the auditor's report. Because of this significance of the auditor's report, it should clearly describe the auditor's work. In addition, there must be a common understanding of the terminologies and phrases used in the audit report.

Several studies pointed out that the expanded audit report gives a fuller understanding of the scope, nature and limitations of the audit work and influences the perceptions of financial statements users concerning the audit and the auditor's responsibilities. On contrast, other studies found that there are still differences between perceptions of the auditors and users in relation to the meanings of the audit report. The detailed explanations of the auditor and management responsibilities and scope of the audit provided by the expanded audit report may have a detrimental effect. Different perceptions of auditors and users of the audit report are related to three main issues contained in the audit report. These issues are; report on the responsibility of the auditors and management, report on the going concern and report on the internal control system.

Actually, many users of audit report expect that auditors guarantee that audited financial statements were completely accurate and the auditor has performed one hundred percent audit for client whose financial statements received an unqualified audit report. This is due to public's lack of knowledge about auditor's responsibilities which is referred to as "knowledge gap" by Gowthorpe & Porter (2002).

The earlier discussion in this manuscript argues strongly for the significance of the messages conveyed and implications of the audit report for users and for the existence of a "gap" between users and auditors regarding the meanings of the audit report. This gap might be bridged by augmentation of the auditing, strengthening of the integrity auditors, and educating users on the nature and functions of audit. The entire issue of the users' perceptions of the audit report should subject to further research. The future research in this area should propose modifications on the existing audit report so as to reflect the actual audit work and to avoid misunderstanding of the report by users. Among these suggested modifications is the reordering of the sections of the report by placing the opinion at the start of the report may be useful in reducing the gap and providing information regarding materiality threshold in the auditors report.

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Sarbanes Oxley Act, (2002)

Annexes

Annex 1. Example of Standard Unqualified Audit Report Used in the United Kingdom until 1993

Report of the auditors

To the members of the Peninsular and Oriental Steam Navigation Company

We have audited the accounts on the pages 27-49 in accordance with Auditing Standards.

In our opinion, the accounts give a true and fair view of the state of affairs at the Company and the Group at 31 December 1991and of the profit and cash flows of the Group for the year then ended and have been properly prepared in accordance with Companies Act 1985.

London KPMG Peat Marwick

24 March 1992 Chartered Accountants

Registered Auditor

Annex 2. Example of Standard Unqualified Audit Report as Required by ISA700

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Consolidated Financial Statements8

We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's9 Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards,1 and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on he auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation11 of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.12 An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of ABC Company and its subsidiaries as at December 31, 20X1, and (*of*) their financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]